Recommendation No 1/2014
of Národná banka Slovenska
of 7 October 2014

in the area of macroprudential policy
on risks related to market developments in retail lending

Národná banka Slovenska, in accordance with Article 1(3)(a) point 3 and Article 2(9) of Act No 747/2004 Coll. on financial market supervision, as amended, and with Article 6(19) of Act No 483/2001 Coll. on banks, as amended, has adopted this Recommendation:

Article I
Purpose

The current situation in the retail lending market is one of the principal factors affecting the stability of the banking sector in Slovakia. This relates mainly to housing loans, since their recent growth rate has been among the highest in any EU country. Loan refinancing has also had a significantly increasing impact.

Národná banka Slovenska does not view growth in household lending as detrimental to the stability of the Slovak financial sector. Likewise, a certain amount of loan refinancing stimulates competition in the retail lending market. Looking, however, at the stability of the financial sector as a whole, it is important that such trends are founded on sound banking practices and do not store up future risks for banks and their customers.

Through its publications, Národná banka Slovenska has repeatedly drawn attention to the trend growth in housing loans that have a higher loan-to-value (LTV) ratio. For a relatively large proportion of new housing loans, the LTV ratio is 100%. This may accentuate the risk of imbalances emerging in the property market, with adverse repercussions for banks, their customers and the economy as a whole.

In the view of Národná banka Slovenska, it is vital that banks appropriately assess retail customers' ability to repay their bank loans. Particularly when prevailing interest rates are low, it is important that the customer's ability to repay is assessed on a sufficiently conservative basis, with regard to, inter alia, the risk of an increase in future interest rates and therefore in instalments.

Loan products meriting special attention in this regard are those that allow very prolonged repayment of the principal. These include loans with an unduly long maturity and loans with deferred payment. In the view of Národná banka Slovenska, the provision of such loans should cease in order to maintain stability in the retail lending market.

As regards the upward trend in loan refinancing, it is incumbent on banks to ensure that any refinancing that includes a significant increase in the loan principal is accompanied by an appropriate reassessment of the customer's repayment capacity.

Národná banka Slovenska has in the past warned of potential risks to both banks and their customers related to the rising proportion of new retail loans that are provided through financial intermediaries. Národná banka Slovenska therefore urges banks to take a prudent approach to such lending.

The Slovak banking sector has long been assessed by Národná banka Slovenska as stable with relatively strong resilience to potential risks. In order to support the banking sector's stability from the macroprudential level, and in conjunction with Article 27 of Act No 483/2001 Coll. on banks as amended ('the Banking Act'), Národná banka Slovenska hereby issues recommendations A to G for banks and branches of foreign banks. The purpose of these recommendations is to help mitigate the risks mentioned above as well as to maintain the sound functioning of the retail lending market.

The recommendations are formulated with regard to banks' current internal systems and risk management methodologies, not on the assumption that these will be replaced.

Article II
Scope

(1) This Recommendation on risks related to market developments in retail lending applies to banks and branches of foreign banks operating in Slovakia in accordance with the Banking Act (hereinafter referred to as 'banks').

(2) Recommendation A, stated in Article IV, and the first part of recommendation F, stated in Article IX, paragraph 1, concern all secured housing loans.

(3) Recommendation D, stated in Article VII, concerns all housing loans.

(4) Recommendations B, C, E and G, stated in Articles V, VI, VIII and X, respectively, and the second part of recommendation F, stated in Article IX, paragraphs 2 and 3, concern all retail loans.

Article III
Definitions

For the purposes of this Recommendation, the following definitions shall apply:

(1) 'secured loan' means a loan that a bank secures with a senior interest in real property registered at the Land Registry. Such loan may also be secured by another senior security interest of that bank which is registered at the Land Registry, or by a senior security interest, registered at the Land Registry, where it is an interest in claims arising from a transfer of title to residential or non-residential property pursuant to Article 15 to 18b and Article 23 of Act No 182/1993 Coll. on ownership of residential and non-residential premises as amended or an interest held by the State Housing Development Fund, or where it arises upon the drawdown of a housing loan by which a security interest held by another bank is discharged. For the purposes of this Recommendation, loans not secured in the way mentioned above shall be deemed unsecured;

(2) 'retail loan' means a loan provided by a bank to a natural person regardless of whether it is secured or designated for a specific purpose; it does not include credit card facilities, current account overdrafts, or business loans for individuals. The term 'loan' in this Recommendation is to be understood to mean 'retail loan' unless otherwise stated;

(3) 'housing loan' means a secured retail loan regardless of whether it is granted for a specific purpose, or a retail loan provided by home savings banks for building purposes

(pursuant to Article 11 of Act No 310/1992 Coll. on home savings as amended), regardless of whether it is secured ;

(4) 'loan approval date' means the date when the respective retail loan or housing loan agreement becomes effective;

(5) 'customer' means a natural person who receives a retail loan from a bank;

(6) 'appraiser' means an appraiser as defined in Act No 382/2004 Coll. on experts, interpreters and translators as amended;

(7) 'housing loan amount' means the amount of the principal of a housing loan as stated in the respective credit agreement;

(8) 'loan-to-value (LTV) ratio' means the ratio of a customer's housing loan-related debt as defined in (9) to collateral value as defined in (10);

(9) 'housing loan-related debt' means the sum of a housing loan to be provided to a customer and the outstanding principals of all housing loans provided to the customer, regardless of drawdown date, which are secured by the real estate for which the housing loan is to be obtained;

(10) 'collateral value' means:

a) in the case of collateral which is the subject-matter of a purchase agreement, either the purchase price of the property or value of the property set by an appraiser, whichever is lower. Banks may at their discretion revise down this value on the basis of their internal appraisal of the property. If the purchase price of the property pledged as collateral is not available or the price agreed between related parties did not reflect the market value, only the value set by an appraiser or the value determined in the bank's internal appraisal process is to be taken into account;

b) in the case of collateral which is a property under construction, the projected value of the property after its completion, determined in accordance with the bank's internal appraisal;

c) in other cases, the value of the property determined in accordance with the bank's internal appraisal.

The valuation of collateral concerns only the securing of loans pursuant to paragraph 1. Where the property being pledged as collateral is already subject to a security interest in favour of the State Housing Development Fund, the collateral value is to be reduced by the amount corresponding to that interest. Where a housing loan is secured by several pieces of real property, the collateral value is to be calculated as the sum of the values of these properties determined in line with points (a) to (c). For the purposes of this Recommendation, the valuation of collateral does not take account of other internal adjustments and techniques applied by banks within the risk management process, such as insurance against foreclosure losses on housing loans with higher LTV ratios;

(11) 'indicator of customer repayment ability' means a household customer's total debt servicing requirements, including the new loan, as a percentage of their income less standard living costs (especially expenditure on housing, energy, telecommunication services, insurance, personal consumption, children, and statutory expenses);

(12) 'loan with deferred payment' means a loan where the credit agreement allows payment of the principal or interest to be (partially) deferred, instalments to be progressively increased, interest payments to be temporarily reduced, or instalments to be less frequent

than once a month. It is not considered to be a deferred payment where the interest rate is readjusted at contractual resetting times in response to financial market movements, the interest rate on a mortgage loan is reduced by the grant of a state interest subsidy for young people pursuant to Article 85a of the Banking Act, the interest rate on a housing loan is similarly reduced, cumulatively by not more than 3 percentage points (provided that the amount of each instalment is contractually agreed in advance for the whole term of the loan), or mortgage instalments are reduced upon the birth of a child in accordance with Article 75(4)(h) of the Banking Act. Nor does deferred payment include cases that do not have a significant financial impact on the customer at a later period and pertain to a period not longer than six months from first drawdown of the loan or more than six instalments (for example, marketing campaigns). In the case of gradual drawdown for the financing of a residential real estate construction, this period can be further extended to 18 months;

(13) 'intermediary' means an entity performing financial intermediation or advisory services in accordance with Act No 186/2009 Coll. on financial intermediation and financial advisory services as amended; it does not include tied financial agents.

Article IV
Recommendation A:
Compliance with LTV ratio limits on new housing loans

(1) It is recommended that banks' LTV ratios for secured housing loans do not exceed 90%, except as provided for in paragraph 2.

(2) Banks may raise the maximum LTV ratio mentioned in paragraph 1 for secured housing loans, but they are recommended to ensure that the amount of secured housing loans which exceed this limit and are approved in a given calendar quarter is not more than the following percentage amounts of total new secured housing loans provided in that quarter:

a) 25%, until 30 June 2015;
b) 20%, from 1 July 2015 to 31 March 2016;
c) 15%, from 1 April 2016 to 31 December 2016;
d) 10%, from 1 January 2017.

In addition to these limits, it is recommended that banks' LTV ratios for secured housing loans never exceed 100%. Where a secured housing loan is to be drawn down in stages, the limits stated in this and the previous paragraph are to be applied as of when the secured housing loan is approved, not when it is drawn down.

(3) Further to the definition of collateral value in Article III(10) and LTV ratio limits stated in paragraphs 1 and 2 of this Article, banks should maintain a prudent approach when appraising real estate collateral for their own purposes (this is also pursuant to Article 73 of the Banking Act), which means in particular that they should:

a) check and, if necessary, adjust the independently appraised value of real estate collateral;

b) act prudently in dealings with appraisers, especially those whose valuations have in the past differed markedly from actual purchase prices, or the bank's internal appraisals;

c) periodically reappraise all real estate collateral (by, for example, using statistical models) in order to monitor LTV ratios in the current portfolio.

Article V
Recommendation B:
Setting and adhering to an internal limit for the indicator of customer repayment ability

(1) It is recommended that banks' internal credit risk management systems,[1] established as part of their internal regulations pursuant to Article 27(2) of the Banking Act and in accordance with their approved risk management strategy, include a mandatory limit for the indicator of customer repayment ability to be applied in the provision of retail loans.

(2) The limit mentioned in paragraph 1 should be such that banks should not provide a loan if the customer's expenditure, as referred to in Article III(11), exceeds their income.

(3) It is recommended that banks, whenever they provide a retail loan, assess and comply with limit for the indicator of customer repayment ability.

(4) The recommendation in paragraph 3 does not apply to retail loans other than housing loans where the loan amount is set in a pre-approval process that does not involve the active participation of the customer and is based on the bank's internal or external historical data about the customer's financial situation. Banks are, however, recommended to separately monitor such loans and the attached credit risk.

(5) For the purposes of paragraph 1, it is recommended that banks have at their disposal the information that will allow them to assess the amount and variability of the income of household customers. Where possible, banks should verify income information with independent internal or external sources. A declaration of honour is not to be considered a suitable way of proving income.

(6) For the purposes of paragraphs 1 to 3, the assessment of customer repayment ability should not be influenced by the collateral value, nor should it take account of any other forms of collateral, possibilities for transferring or insuring credit risk, or an expected significant increase in the customer's income. The above-mentioned requirements for the value of real estate collateral should not substitute for the income assessment requirements referred to in paragraph 5.

(7) Where there is a risk of a customer's income declining, banks are recommended to consider being stricter in their setting of the limit for the indicator of customer repayment ability, which is part of their internal system referred to in paragraph 1.

[1] Article 12 of Decree No 13/2010 of Národná banka Slovenska of 31 August 2010 on additional types of risk, on details of the risk management system of banks and branches of foreign banks, and on defining a sudden and unexpected change in market interest rates (Notification No 367/2010 Coll.).

Article VI
Recommendation C:
Maintaining the limit for the indicator of customer repayment ability under adverse conditions

(1) It is recommended that banks, in providing retail loans where the interest rate is not fixed for the entire term of the loan, verify that the limit for the indicator of customer repayment ability pursuant to Article V(1) would still be met in the case that the same retail loan were subject to an interest rate at least 2 percentage points higher than the rate at which the loan was provided and its maturity period were at the maximum maturity limit recommended in Article VIII(1), taking due account of the expected decline in the customer's income on their reaching retirement age. If the limit for the indicator of customer repayment ability would not be met in such circumstances, it is recommended that the loan not be provided, unless the customer can prove that they have sufficient financial assets in reserve.

(2) Where a credit agreement sets the maximum cumulative increase in the interest rate over the term of the loan at less than 2 percentage points, that level shall be used for the purposes of verifying the requirement under paragraph 1. In providing mortgage loans subject to a state interest subsidy for young people (pursuant to Article 85a of the Banking Act), banks are recommended to verify the customer repayment ability under the scenario of the original unsubsidised rate being increased by 2 percentage points. Where a housing loan is provided with an interest rate that is to be reduced cumulatively by not more than 3 percentage points, and with the amount of each instalment over the loan term set in the credit agreement, it is recommended that banks verify the customer repayment ability when the instalment is highest, irrespective of when it is due to be paid.

Article VII

Recommendation D:
Stress testing credit portfolios for increases in interest rates and unemployment

(1) It is recommended that banks stress test their housing loan portfolios periodically, but at least once a year and whenever there is a substantial change in market conditions, in order to estimate in particular the impact of increases in interest rates and unemployment on credit losses.

(2) Banks' stress test scenarios should assume the increase in interest rates currently expected by the market, according to forward curves, over a horizon of five years (but an increase not lower than 3 percentage points), while at the same time simulating the performance of particular loans where the customer becomes unemployed or experiences a substantial decline in income from business activities, after taking into account any risk mitigation techniques (e.g. insurance).

(3) It is recommended that banks' stress testing outcomes be reported to the senior management on a regular basis and be taken into account when revising internal procedures for the assessment of the indicator of customer repayment ability and when setting the limit for this indicator pursuant to Article V(1).

Article VIII
Recommendation E:
Compliance with maturity limits for retail loans and avoiding providing retail loans with deferred payment

(1) Banks are recommended to ensure that no more than 10% of the new housing loans they provide in a given calendar quarter have a maturity of more than 30 years. In addition, banks are recommended not to provide retail loans other than housing loans with a maturity of more than:

a) 9 years, from 1 March 2015 to 31 December 2015;

b) 8 years, after 1 January 2016.

Where the term of a retail loan extends beyond the customer's retirement age, banks should take due account of the decline in the customer's income expected during retirement when assessing their ability to repay this retail loan.

(2) Banks are recommended not to provide retail loans with deferred payment as defined in Article III(12).

Article IX
Recommendation F:
Maintaining a prudential approach to loan refinancing where the outstanding principal is significantly increased

(1) Where the refinancing of existing retail loans with a new housing loan from the same or another bank involves increasing the sum of outstanding principals of the refinanced loans and this increase exceeds either €2,000 or 5% of the sum of the outstanding principals, whichever is lower, banks are recommended to comply with the LTV ratio limits mentioned Article IV. The LTV ratio is to be calculated on the basis of the current collateral value, determined by the bank's internal appraisal process. The limits are not to be applied where the refinancing of existing retail loans with a new housing loan from the same or another bank does not involve increasing the sum of outstanding principals of the refinanced loans by €2,000 or 5% of the sum of the outstanding principals, whichever is lower.

(2) Before increasing the outstanding amount of a customer's retail loans by more than €2,000 or 5% of the sum of outstanding principals of the refinanced loans, whichever is lower, whether through refinancing or otherwise, banks are recommended to reassess compliance with the limit for the indicator of customer repayment ability pursuant to Articles V and VI, unless this increase was agreed when providing the original loans and was taken into account in the assessment made for those loans. The reassessment should include verification of the customer's compliance with the limit for the indicator of customer repayment ability, based on current data about their household income for which sufficient evidence is adduced and independently corroborated pursuant to Article V(5).

(3) When providing a retail loan that is to refinance existing retail loans from the same or another bank, banks are recommended to ensure that the term of the new retail loan is in

accordance with the maximum maturity limits for retail loans mentioned in Article VIII(1). This does not apply where the increase in the sum of outstanding principals of the refinanced loans would not exceed €2,000 or 5% of the sum of the outstanding principals, whichever is lower, and, at the same time, the maturity of the new loan is not longer than the remaining maturity of any of the refinanced loans.

Article X
Recommendation G:
Maintaining a prudential approach to lending through intermediaries

(1) When providing retail loans through intermediaries, banks are recommended to proceed prudently. For this purpose it is recommended that banks separately assess and manage the credit risk on loans provided through intermediaries and comply with recommendations A to F in respect of such loans.

(2) Banks should ensure that, in their retail loan portfolios, the share of loans provided through intermediaries is such that does not create pressure to loosen lending conditions. Furthermore, banks are recommended to maintain an appropriately diverse pool of intermediaries through which they provide loans to customers.

(3) It is recommended that banks separately monitor retail loans provided through intermediaries, particularly in order to assess whether these loans carry greater risk than do the other retail loans they provide.

Article XI
Assessing compliance with the recommendations

(1) Národná banka Slovenska will assess banks' compliance with each of the recommendations on a regular basis.

(2) The first assessment will be conducted in the second quarter of 2015. In this assessment, Národná banka Slovenska will focus on banks' compliance with the recommendations that should be implemented in full as from the commencement date and the extent of their implementation of recommendations that have a longer implementation period, as follows:

   a) for recommendation A stated in Article IV, compliance with paragraphs 1 and 2 and the extent of implementation of paragraph 3. The assessment of compliance with paragraphs 1 and 2 will be made on the basis of quantitative data. The first data will be collected for the periods from 1 November 2014 to 31 December 2014 and from 1 January 2015 to 31 March 2015;

   b) for recommendation B stated in Article V, compliance with paragraphs 1 to 7;

   c) for recommendation C stated in Article VI, compliance with paragraphs 1 and 2;

   d) for recommendation D stated in Article VII, the extent of implementation of paragraphs 1 to 3;

   e) for recommendation E stated in Article VIII, compliance with paragraphs 1 and 2;

f) for recommendation F stated in Article IX, compliance with paragraphs 1 to 3;

g) for recommendation G stated in Article X, the extent of implementation of paragraphs 1 to 3. For the purposes of paragraph 2, monitoring will be carried out on the basis of quantitative data.

(3) The subsequent assessment will be conducted when necessary, at least once a year. Compliance with the provisions of Article IV(3), Article VII and Article X will be assessed at the end of 2015.

(4) As for compliance with the provisions of Article IV(1) and (2) and Article X(2) and the monitoring of retail loans where the loan amount is set in a pre-approval process that does not involve the active participation of the customer and is based on the bank's internal historical data about the customer's financial situation, as referred to in Article V(4), these will be assessed periodically using data collected on a quarterly basis.

Article XII
Commencement

This Recommendation enters into force on 1 November 2014, with the exception of recommendations B, C, D, E, F and G, stated in Articles V, VI, VII, VIII, IX and X, which enter into force on 1 March 2015.

Jozef Makúch

Governor